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CLIENT MEMORANDUM

Elimination of Fiduciary Duties in Publicly Traded Delaware Limited Partnerships

A warning to investors and a road map to controllers
MLPs may not be just for oil and gas anymore

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In the latest in a series of cases examining fiduciary duties in publicly traded Delaware limited partnerships, the Delaware Supreme Court has once again upheld the limitation of fiduciary duties in a limited partnership agreement (an "*LPA*") and dismissed a unitholder suit. In *Encore Energy Partners,*[1] the Court held that the standard imposed on the board members by the LPA was only one of "subjective good faith." Since the plaintiff's complaint did not plead facts that implicated a breach of that standard, the Delaware Supreme Court upheld the dismissal of the suit. Interestingly, the Court strongly implied that if the company had been a Delaware corporation, the suit would have been allowed to proceed.[2]

There are three key lessons from *Encore Energy Partners*:

- Controllers of publicly traded Delaware limited partnerships should carefully draft the standards applicable to board members and other similarly situated parties.

1 *Allen v. Encore Energy Partners, L.P. (Del. July 22, 2013)* ("Encore Energy Partners").

2 "[w]hile allegations that the [Conflicts Committee] failed . . . to negotiate the best deal available might suffice to state a colorable claim for breach of the traditional fiduciary duties of care and loyalty, these allegations do not suggest the type of subjective bad faith required to state a claim under" the LPA. *Encore Energy Partners* at 29-30 (internal citations omitted).

- Investors in publicly traded Delaware limited partnerships should understand and weigh the risks of investing in particular partnerships based on the applicable corporate governance standards.
- Regardless of industry, a controlling stockholder wishing to take a company public and to maintain control should consider using a publicly traded Delaware limited partnership to achieve those goals.

The Willkie Farr & Gallagher team stands ready to help you implement these lessons.

Background

In late 2010, Vanguard Natural Resources, LLC ("*Vanguard*") acquired the general partner ("*Encore GP*") and 46% of the common units of Encore Energy Partners, L.P. ("*Encore*"). The plaintiff alleged that Vanguard then engaged in a campaign to depress Encore's price, including by lowering projections (which in hindsight turned out to be unduly gloomy) and cutting Encore's distributions to unitholders. The alleged purpose was to enable Vanguard to buy the rest of Encore on the cheap. In March 2011, Vanguard proposed acquiring Encore in a unit-for-unit exchange. The Encore GP board formed a Conflicts Committee of independent directors, which retained independent counsel and financial advisors. The Conflicts Committee negotiated an increase in Vanguard's proposal and approved a merger agreement. The merger was approved by the Encore unitholders (including Vanguard voting its 46% position), and the merger closed.

The Lower Court Decision

Plaintiff unitholders sued, alleging that the defendants "*breached their contractual duties to the class members by proposing, approving and consummating a transaction that was unfair, unreasonable, and undertaken in bad faith*." The Delaware Court of Chancery dismissed the complaint, and the plaintiff appealed. [3]

The Delaware Supreme Court Decision

On July 22, the Delaware Supreme Court upheld the Chancery Court in an opinion that strongly favored the ability of Delaware limited partnerships to eliminate any fiduciary duty that one partner owes to the limited partnership or another partner, provided that "the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing." [4]

[3] *Encore Energy Partners* at 12.

[4] *Encore Energy Partners* at 14.

Specifically, the Delaware Supreme Court found that the standard applicable under the Encore LPA was whether the directors acted in "**subjective good faith**."[5] Thus, the plaintiff had to show that a director either (1) believed he or she was acting against Encore's best interest when approving the merger, or (2) consciously disregarded his or her contractual duty to form a subjective belief. In the words of the Court, "[i]t would take an extraordinary set of facts to do that." [6] Since the plaintiff did not plead such an extraordinary set of facts, the dismissal of the suit was affirmed.

Key Takeaways for MLPs

The key takeaways for sponsors of, and investors in, publicly traded Delaware limited partnerships are (1) that sponsors have the ability to draft virtually insurmountable barriers to claims of breach of duty to the limited partnership, and (2) that Delaware courts will respect those provisions. As the Delaware Supreme Court stated:

> [Plaintiff] entered into a limited partnership agreement that created a duty of subjective good faith. Therefore he has no contractual basis to argue that the LPA required the Conflicts Committee to bargain to his satisfaction or to achieve a better result. *If [plaintiff] seeks the protections the common law duties of loyalty and care provide, he would be well-advised to invest in a Delaware corporation. He is bound by his decision to forgo these protections.* [7]

Key Takeaway for Controllers – MLPs aren't just for Oil and Gas Anymore

In order to take advantage of "pass-through" tax treatment permitted to certain oil and gas companies under the tax code, a publicly traded oil and gas company will typically organize as a limited partnership. Having chosen to organize as limited partnerships for the tax treatment, those companies, under the 'law of unintended consequences,' find themselves in a position to take advantage of provisions of Delaware law that permit the virtual elimination of fiduciary duties in Delaware limited partnerships.[8] *Encore Energy Partners* is only the most recent example of a court upholding those provisions.

Currently, a controlling shareholder outside of the oil and gas industry that wishes to take a company public and to maintain control typically uses a corporation with two classes of stock: one with a high vote that is retained by the controller, and one with a low vote that is sold to the public. The problem, from the controller's point of view, is that the

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5 In an analysis that only a lawyer could love, the Court reasoned that since the LPA used the phrase "reasonable belief" in connection with certain provisions, but not in connection with the standard applicable to the directors, the standard should not be a reasonable (i.e., objective) standard, but a subjective one. *Encore Energy Partners* at 21-22.

6 *Encore Energy Partners* at 24-25.

7 *Encore Energy Partners* at 32 (emphasis added).

8 Delaware Revised Uniform Limited Partnership Act §17-1101(d).

director designees of the controller and the controller itself still owe fiduciary duties to the corporation and the other stockholders.

There is nothing that restricts a business outside of the oil and gas industry from organizing as a Delaware limited partnership that elects to be taxed as a corporation. A controlling stockholder using that structure would retain the general partnership interests and sell the limited partnership interests to the public. The controlling stockholder presumably would adopt the court-approved limitations on fiduciary duty contained in the litigated-over oil and gas publicly traded limited partnerships to minimize the exposure to future lawsuits. In addition, by retaining a general partnership interest, the controller would maintain the ability to receive a control premium upon an ultimate sale. From a controller's standpoint, this would seem to have many advantages over a two-tiered stock structure. It remains to be seen whether the market would accept such a structure outside of the oil and gas industry or would impose a discount on the trading price for such a structure, but there is no inherent reason for a controller not to try.

If you have any questions regarding this memorandum, please contact Maurice M. Lefkort (212-728-8239, mlefkort@willkie.com) or the Willkie attorney with whom you regularly work.

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